Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
The Library of Congress
Washington, D.C.

In re **DETERMINATION OF ROYALTY RATES AND TERMS FOR MAKING AND DISTRIBUTING PHONORECORDS (Phonorecords III)**	**Docket No. 16–CRB–0003–PR (2018–2022) (Remand)**

SERVICES' JOINT SUPPLEMENTAL BRIEF ADDRESSING THE JUDGES' WORKING PROPOSAL

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases **Page(s)**

Statute

Other Authorities

Pursuant to the Judges' Notice and *Sua Sponte* Order Directing the Parties to Provide Additional Materials, eCRB Docket No. 25965 (Dec. 9. 2021) ("December 9 Order"), the Judges' Order Following Status Conference and Modifying Scheduling Orders, eCRB Docket No. 25973 (Dec. 13, 2021) ("December 13 Order"), and the Judges' Order Granting in Part and Denying in Part Copyright Owners' Motion for Reconsideration or, in the Alternative, Clarification, eCRB Docket No. 26007 (Jan. 6, 2022) ("January 6 Order"), Amazon.com Services LLC, Google LLC, Pandora Media, LLC, and Spotify USA Inc. (collectively, the "Services") respectfully submit this joint brief responding to the Judges' request for input on the proposed rate structure and approach for calculating rate levels described in the December 9 Order (the "Working Proposal").

INTRODUCTION

The Working Proposal in the Judges' December 9 Order should be modified so that it can result in rates that can satisfy the governing standard of Section 801(b)(1). The Working Proposal flows from the Judges' finding that the major record labels "are unregulated complementary oligopolists" that "do not retain so much of the Services' revenue that they deprive the interactive service sector of revenues sufficient to allow them to survive." Working off that premise, the Judges' new rate-setting formula leaves the Services with what the December 9 Order describes as their "survival" rate, while dividing the remaining revenue between the sound recording and musical works rightsholders. But a "survival" rate does not provide the Services with a fair income, nor does it reflect the Services' role in developing interactive streaming offerings. In addition, for the Services to retain even that "survival" rate, record labels would have to reduce their rates in response to the Judges' new rate-setting decision. The record shows [redacted], and as a practical matter, it cannot happen now that the *Phonorecords III* rate period has nearly ended. For the reasons we explain, without modification, the Working Proposal will not result in rates that are effectively competitive, reasonable, or fair. But, with modification, the Working Proposal can lead to rates that satisfy the four statutory objectives of Section 801(b)(1) and the *Johnson* remand. In the alternative, the Judges can satisfy the Section 801(b)(1) factors by setting rates and terms based on the *Phonorecords II* settlement. The Services continue to believe that using the *Phonorecords II* settlement as a benchmark is the best approach to rate-setting here and that adoption of the Services' Proposal is the most reasonable and straightforward outcome in this proceeding.

In Section I, the Services provide the Judges with the best evidence from the record to use as the "total royalty" input into their new rate-setting formula and explain why that input is superior to the other inputs the Judges may be considering. That evidence shows that a total royalty rate of [redacted]% best approximates the major labels' apparent view of the "survival" rate for interactive streaming services ([redacted]%) over the *Phonorecords III* period. That [redacted]% rate is the sum of the [redacted] agreements with the major record labels ([redacted]) and the headline musical works rate applicable at the time those sound recording rates were negotiated (10.5% of revenue). Using that combined royalty rate as the input into the formula set forth in the December 9 Order without any modification would yield an all-in musical works rate of [redacted]% of revenue.

In Sections II and III, the Services identify three problems with the Working Proposal and propose modest adjustments to the Working Proposal to address these concerns, so that the Working Proposal can yield rate levels that can satisfy the Section 801(b)(1) factors. Those three problems include, first, that the proposed methodology—by design—leaves the Services with only their "survival" rate, rather than a rate that affords them a "fair income" for their contributions or one that reflects their "relative role[]" in developing the market for interactive streaming and bringing back the songwriting and music publishing industries from years of decline. 17 U.S.C. § 801(b)(1)(B)-(C) (2006). Second, the Working Proposal fails to adequately temper the effect of the major record labels' "complementary oligopoly" power—market power that has been repeatedly recognized by the D.C. Circuit and the Judges. And third, the Working Proposal reflects an embedded assumption that record labels will reduce their royalty demands to fully offset any increase in musical works rates. But [redacted]. And with the rate period nearing its end, [redacted]. When the Working Proposal is modified to address each of these issues, the resulting rates are in line with those found in the *Phonorecords II* settlement, which is a proper benchmark for reasons the Services and Judge Strickler have previously identified.

In Section IV, the Services explain why they agree with the Judges that, if the Judges proceed with the Working Proposal as modified, there is no need to maintain the TCC prong (especially if left uncapped). Jettisoning that prong would help address the significant concerns raised by the D.C. Circuit and Judge Strickler in dissent about "yok[ing] the mechanical license royalties to the sound recording rightsholders' unchecked market power." *Johnson v. Copyright Royalty Bd.*, 969 F.3d 363, 367, 382 (D.C. Cir. 2020). Moreover, if a percentage-of-revenue rate derived from the Working Proposal were paired in a greater-of structure with a TCC prong, the resulting industry-wide effective rate would necessarily be *higher* than the headline rate if some of the Services ever paid royalties under the TCC prong. That alternative prong would therefore result in the Services being left with an even smaller portion of their revenues than the Working Proposal's underlying premise says they should retain.

In Section V, the Services explain why their economic experts' preferred approach to setting rate levels here—using the *Phonorecords II* settlement as a benchmark—is superior to the Working Proposal's game-theoretical approach and its reliance on a host of assumptions that are inconsistent with evidence from real-world transactions. The Services also respond to the Judges' additional questions concerning use of the *Phonorecords II* benchmark, including those pertaining to rate structure if that benchmark is used to set rate levels.

Finally, in Section VI, the Services respond to the Judges' request for clarification regarding "new agency action" and its implications regarding the Service Revenue definition for bundles. The Services and Copyright Owners agree that this proceeding is "new agency action." But they disagree on what follows. The Copyright Owners erroneously assert that, by taking new agency action, the Judges may bypass the question the D.C. Circuit remanded—the source of the Judges' authority under the Copyright Act to modify the Service Revenue definition—and go straight to the substance of the definition itself. Instead, under both the mandate rule and the Copyright Act, that remanded question remains a threshold legal question the Judges must answer before considering any changes to the definition. By taking new agency action, the Judges may rely on new arguments for why they have such authority and are not confined to offering a fuller explanation of their previous reasoning. However, as the Services have shown—with no serious response from the Copyright Owners—the terms of the Copyright Act, the D.C. Circuit's ruling in *Johnson*, and the Judges' prior, correct findings in this proceeding all confirm that no such authority exists. Accordingly, the Judges lack the legal authority to modify the definition adopted in the Initial Determination.

ARGUMENT

I. A TOTAL ROYALTY RATE OF [redacted]% IS THE MOST APPROPRIATE RATE FROM THE RECORD TO INCORPORATE INTO THE WORKING PROPOSAL PRIOR TO MAKING NECESSARY ADJUSTMENTS

As set out in the December 9 Order, the Judges are seeking record evidence (including from the record on remand) identifying for "the relevant period" the percentage of total service revenues that "the Majors agreed to allow the interactive services to retain" so that those services can "survive." Dec. 9 Order at 2-3, 5 & n.2. That Order posits using a "market-derived" data point as the key input into a formula that the Judges consider a potential "appropriate method . . . for setting an 'effectively competitive,' 'reasonable,' and/or 'fair'" all-in musical works royalty rate. *Id*. at 2-3.

This new rate-setting methodology thus starts by assuming that the major labels take from the Services all of the revenues generated by their interactive streaming offerings that, when combined with the musical works royalties, leave the Services with just the amount that the major labels have concluded is necessary for them to "survive." The Working Proposal then arrives at an all-in musical works rate by splitting that above-survival revenue (that is, the total royalty) between the sound recording and musical works rightsholders using a 3.82:1 sound recording-to-musical works royalty ratio. *Id*. at 2-3. The Judges' new rate-setting formula can be expressed arithmetically as follows:

All-in Musical Works Royalty Rate = .262 * [(1 – Service "Survival" Rate) / 1.262].[1]

While the Services respectfully submit that, for the reasons detailed in Section II below, this approach to rate-setting does not satisfy the governing rate-setting standard and yields rates

---

[1] Dec. 9 Order at 3. This presentation of the formula from the Working Proposal is mathematically equivalent to the multi-step formula set out in paragraph 7 of the December 9 Order.

that are higher than those that are "effectively competitive," "reasonable," or "fair," *id.* at 3, the Services in this Section are responding to the Judges' request and identifying the most appropriate input from the record to use to derive a musical works rate, should the Judges utilize the approach outlined in their December 9 and January 6 Orders. The best record evidence of the total royalty that the major labels determined would permit the survival of the interactive streaming services is the total royalty [redacted] paid at the time the record labels agreed to provide [redacted], *i.e.*, before the *Phonorecords III* determination, ensuing appeal, and remand proceedings took place. In those deals, which were reached at a time when the *Phonorecords II* rates were in place, the major labels agreed to a [redacted]%. Written Second Supplemental Remand Testimony of Leslie M. Marx, PhD ¶ 17 (Marx WSSRT). Combining that rate with the *Phonorecords II* all-in headline rate of 10.5% for musical works and inputting the total ([redacted]%) into the Judges' proposed rate-setting formula results in an all-in musical works rate of [redacted]% (0.262 * ([redacted]% / 1.262) = [redacted]%).[2]

A. The Most Appropriate Input to Use in the Judges' New Rate-Setting Formula Is the Total Royalty Emerging from [redacted] with the Major Labels

As Professor Marx and Dr. Leonard explain, the best available market-based evidence of the "survival" rate for use in the Judges' new rate-setting formula is the combination of the [redacted] rate the major labels accepted from [redacted] combined

[2] If the Judges conclude that a rate above the 10.5% headline rate from the *Phonorecords II* benchmark is appropriate, that elevated rate should be phased in over the five-year license term as the Judges "commonly do when setting new license royalty rates." Dec. 9 Order at 4. Among other reasons, the Majority's prior conclusion to phase in elevated rates so as to "mitigate the risk of short-term market disruption" was not challenged by any party, and the Copyright Owners' proposal in this remand proceeding calls for phased-in headline rates beginning with 11.4% in 2018 and 12.3% in 2019. *Determination of Royalty Rates and Terms for Making and Distributing Phonorecords* (*Phono III*), Final Rule, 84 Fed. Reg. 1918, 1960 (Feb. 5, 2019).

with the 10.5% all-in headline musical works royalty that was applicable at the time of those negotiations, for a total royalty of [redacted]%. Marx WSSRT ¶¶ 16-19; Written Second Supplemental Remand Testimony of Dr. Gregory K. Leonard ¶ 20 (Leonard WSSRT). This combination is the best input to the Judges' formula for several reasons.

First, the Judges have routinely looked to the rates paid by [redacted], rather than industry-wide averages, when setting statutory rates, both in this proceeding, and in others. In *Web V*, for example, the Judges looked to [redacted] rates to answer the same question they now explore: what royalty rate will the major labels impose on an interactive service where they have an interest in ensuring that the service survives in the marketplace? *See* Final Determination at 50-59, *In re Determination of Rates and Terms for Digital Performance of Sound Recordings and Making of Ephemeral Copies to Facilitate Those Performances* (*Web V*), No. 19-CRB-0005-WR (2021-2025) (Jul. 22, 2021). The Judges concluded that the [redacted] rate paid by [redacted] to the major labels answers this question. Among many other findings, the Judges concluded that:

- [redacted] *Web V* at 54 (emphasis added).
- [redacted] *Web V* at 57 (emphasis added).
- [redacted] *Web V* at 15 (emphasis added).

In short, the [redacted] royalty rate that the major labels negotiated with [redacted] provides, by the Judges' own prior reasoning, the precise sound recording "survival" rate that the Judges seek for their new rate-setting formula.

To arrive at the total royalty that the Judges are seeking as an input to their formula, this sound recording rate should be combined with the *Phonorecords II* musical works royalty rate that was applicable at the time of these negotiations and that had been in place for nearly a decade—the rate that the major labels would have had to consider if they were making decisions regarding how much revenue to leave [redacted] at the time so that it could survive. Marx WSSRT ¶ 15; Leonard WSSRT ¶¶ 20-21. There is no evidence that the major labels expected musical works rates to change, much less that they factored any expected change (up or down) into their analysis of what rates to accept from [redacted]. And any notion that major labels expected musical works rates to increase is incompatible with the Judges' finding that the major labels [redacted]. As discussed at length in *Web V* and confirmed by [redacted]. *Web V* at 50-59; [redacted].

Second, the timing of the negotiations between [redacted] and the major labels is ideal for purposes of answering the Judges' question. These agreements were all [redacted], providing evidence of the major labels' view of [redacted] "survival" rate [redacted] and prior to the date of the Initial Determination. Marx WSSRT ¶¶ 15, 17; Leonard WSSRT ¶¶ 20-21. Moreover, [redacted]

[redacted]. As a result, they provide powerful evidence of "survival" rates as dictated by the major labels [redacted].

Third, it is appropriate to look to the rates the major labels have secured from [redacted] as the best-available evidence of "survival" rates because [redacted].[3] Moreover, [redacted]. Marx WSSRT ¶ 15; Leonard WSSRT ¶¶ 20-21. Throughout this proceeding, the Copyright Owners have raised concerns about potential complications associated with revenue streams from [redacted] and from non-music product lines. Looking to [redacted], minimizes these concerns.

Finally, the [redacted]% all-in rate is consistent with the *Phonorecords III* testimony of [redacted]. As the Judges note in the January 6 Order, [redacted]. Jan. 6 Order at 10-11 ([redacted]). The [redacted]% combined royalty rate that the major labels intended to saddle [redacted] with falls squarely within this range. Put differently, the present record reflects that the major record labels agreed with [redacted]

[3] [redacted] *Web V* at 49-50 n.51. Were the Judges inclined to use a blended rate across all interactive services, the rates paid by [redacted] *Id*. at 99.

[redacted], further reinforcing that the rate that should be used in the Judges' new formula is [redacted]% (prior to making necessary adjustments).

B. Headline Rates Rather than Effective Rates Are Better Suited for Use in the Working Proposal

For all of the reasons addressed above, the rates that the major labels imposed on [redacted], when combined with the musical works rates then in effect, provide the best record evidence of the "survival" rate to use in the Judges' new rate-setting formula. And in developing that figure, the Judges should look to the headline rates, rather than the effective rates, for sound recordings and musical works that [redacted] paid following those [redacted] agreements with the major labels. Indeed, unless the Judges were to modify the Working Proposal to eliminate *all* alternative rate prongs, the headline rates are the only approach consistent with the Working Proposal.

Most fundamentally, headline rates are appropriate because the Judges appear to be contemplating incorporating the all-in musical works rate into a rate structure that includes mechanical-only floors. Dec. 9 Order at 4. Mechanical-only floors can pull ([redacted]) rates above the percentage-of-revenue rate, which operates as the "headline" rate when situated in a multi-prong rate structure.[4] To perform an apples-to-apples calculation, the Judges therefore should use headline rates to calculate what will be the new headline rate within the statutory rate structure. Moreover, as explained by Professor Marx, headline rates are highly informative as they capture in a straightforward way what the labels were seeking at the time the contracts were negotiated, while effective rates are not always predictable. Marx WSSRT ¶ 16.

---

[4] If the Judges decide to also keep the TCC prong (even if capped), there will be even more rate-setting prongs that could push the effective musical works rates up.

As between headline and effective rates, using headline rates also reduces (but does not eliminate) the risk that the Services will be left with something less than the survival rate implied by the Judges' rate-setting methodology. Were the Judges to use *effective* rates as the input to their formula, and were any of the other rate prongs (*e.g.*, mechanical floors) in the resulting rate structure to bind for even one offering, the effective musical works rate actually paid by the Service across all offerings would be *higher* than the rate the Judges' new methodology implies the Services should pay. Once the Services paid musical works and sound recording royalties, they would be retaining *less* than the survival rate implied by the Judges' new methodology.[5] Leaving the Services with something less than their "survival" rate could not possibly satisfy the governing rate-setting standard. *See infra* Section II. To mitigate the risk that the Services retain even less than their survival rate, the Judges should look to headline rates as the input to their new rate-setting formula.[6]

Despite the foregoing, if the Judges are nevertheless inclined to use effective rates and to make the necessary adjustments to the rate structure such use would require, the record contains the necessary information for them to do so. On the musical works side, [redacted], the year that the major label agreements were finalized, was [redacted]

---

[5] [redacted] *See infra* Section II.B; Marx WSSRT ¶¶ 21-22; Leonard WSSRT ¶¶ 13-14; Written Supplemental Remand Testimony of Michael L. Katz ¶ 6 (Katz WSRT).

[6] For this reason, if effective rates are used to determine the total royalty obligation and the corresponding "survival" rate for the Services, it would be clear error to take the percentage of revenue musical works rate that emerges from the Judges' new methodology and incorporate that into a rate structure with *any* alternative rate prongs that could force the effective rate higher.

[redacted]. Marx WSSRT ¶ 18.[7] Across all three major labels, [redacted]; Marx WSSRT ¶ 17. But if effective rates are going to be used, it is not sufficient to use the effective rate paid just to the major labels—the effective royalty rate paid to all sound recording rightsholders must be used to reflect the true effective rate.[8] [redacted]. Marx WSSRT ¶ 17 & n.23. [redacted]. Accordingly, this [redacted]% rate can, at most, be used as the upper bound of the range of potential inputs into the Judges' new rate-setting formula (prior to making other necessary adjustments). When this upper-bound effective rate is used, and prior to making

---

7 [redacted]. Written Supplemental Remand Testimony of Leslie M. Marx, PhD, ¶¶ 37-39, fig.5. [redacted] *Id.*

8 [redacted]. Marx WSSRT ¶ 17 & n.23.

the other adjustments the Services submit would be necessary, the resulting all-in musical works rate is [redacted]%.[9]

C. Other Potential Total Royalties Addressed in the Judges' January 6 Order Are Not Probative of Market-Based Survival Rates

In their January 6 Order, the Judges raised a variety of other possible total royalty rates for the parties to consider. With the exception of the testimony from [redacted] (prior to making necessary adjustments), these alternative total royalty rates are far less probative of the major labels' views of the rate necessary for the Services to survive over the *Phonorecords III* period and should not be used.

The Judges first point to the testimony from Dr. Eisenach in which he noted (without citation) that there was an "industry standard" split where 70% of service revenues accrued to the sound recording and musical works rightsholders and the remaining 30% was left to the Services. That "industry standard" is long outdated and no longer reflects the percentage of revenue that the major labels have decided the Services need in order to survive. While the major labels did previously secure royalty rates from the Services of [redacted]%, those fee demands led many interactive services to leave the market entirely, Ex. 692 ¶¶ 14-17 (Levine WDT), and, in any event, were subsequently reduced to as low as [redacted]% long before the *Phonorecords III* proceeding. In the case of [redacted]. *See supra* Section

---

[9] 0.262 * ([redacted]% / 1.262) = [redacted]%. If instead of looking to the period during which the agreements between [redacted], the Judges are inclined to look to royalty rates from the *Phonorecords III* period, the result is similar. The effective total royalty paid by [redacted] over the *Phonorecords III* period, according to Dr. Eisenach, was approximately [redacted]%. Eisenach RWRT ¶ 13 & fig.1. When that input is plugged into the Judges' formula, the resulting all-in musical works rate is [redacted]% (0.262 * ([redacted]% / 1.262) = [redacted]%)). However, for the reasons stated above, the Services contend that the use of the [redacted] total royalty is the better approach.

I.A.[10] Because these drops in label demands happened *prior* to the *Phonorecords III* period, it makes little sense to look to the outdated "industry standard" mentioned by Dr. Eisenach. Leonard WSSRT ¶ 22.[11]

The Judges next reference Professor Watt's conclusion that "the range for total royalties [is] 64% to 70% of interactive services revenue, indicating a revenue retention by the Services of 30% to 36%." Jan. 6 Order at 9. That range of total royalty rates, however, is not market-based at all—these are the rates that emerge from Professor Watt's Shapley model. Written Rebuttal Testimony of Richard Watt ¶¶ 28-34 (Watt WRT). As Professor Marx and Dr. Leonard explain, if the Judges' goal is to determine survival rates using actual marketplace data, then it is not appropriate to use the results of a Shapley model. Marx WSSRT ¶ 8; Leonard WSSRT ¶¶ 22, 24-25, 27-30.[12]

Finally, the Judges note that, as part of his Shapley analysis, Professor Watt looked to a [redacted]

---

[10] As noted above, [redacted].

[11] For these same reasons, it would also not be appropriate to look to what the Judges have referred to as a [redacted] found in certain sound recording license agreements as a potential input into the Working Proposal. Jan. 6 Order at 9.

[12] If the Judges are inclined to adopt a total royalty rate emerging from a Shapley model, then they should use the total royalty emerging from the Shapley model that the Majority previously embraced in the Final Determination—[redacted]% of revenue. Final Determination at 75, 87, *Phono III*, No. 16-CRB-0003-PR (2018-2022) (Nov. 5, 2018) (Final Det.) (deriving the musical works rate using the "highest value of overall royalties [[redacted]%] predicted by Professor Marx's model"). Using that total royalty as the input to the Judges' new rate-setting formula yields an all-in musical works rate of [redacted]%. Marx WSSRT ¶ 12.

[redacted]. Jan. 6 Order at 10.[13] [redacted]. Marx WSSRT ¶ 13. When that [redacted], the all-in musical works rate resulting from the Working Proposal is [redacted]%.[14] Because this [redacted], Watt WRT ¶¶ 28-34, the results of that model also cannot be relied upon, providing another basis for rejecting the output of Professor Watt's Shapley model as a potential input into the Working Proposal and, more generally, for rejecting Professor Watt's entire Shapley analysis.

II. THE WORKING PROPOSAL SUFFERS FROM SEVERAL ECONOMIC ERRORS THAT REQUIRE ADJUSTMENT

Although the Services have supplied the input from the record that best approximates the "survival" rate that the record companies would allow a Service to retain, the methodology the Judges outlined in the Working Proposal does not yield rates that are "effectively competitive," "reasonable," or "consistent with the 'fair income'/'fair return' objectives in section 801(b)." Dec. 9 Order at 4. As discussed below in Section V, using the *Phonorecords II* rates and terms

[13] In the Jan. 6 Order, the Judges conclude that if the total royalty is [redacted]% (what is left over after leaving the services with [redacted]% of revenue to cover their non-content costs), then the all-in musical works royalty rate that results from their new rate-setting formula is [redacted]. That appears to be based on using a ratio of **2**.82:1 rather than the **3**.82:1 ratio that the Judges include in their formula. When the 3.82:1 ratio is used, the resulting all-in musical works royalty is [redacted].

[14] 0.262 * ((1 – [redacted]%) / 1.262) = [redacted]%.

as a benchmark, in the manner the Services have proposed,[15] better serves the Copyright Act's goals by affording the Copyright Owners a fair return *and the Services a fair income*, accurately reflecting the parties' relative roles, and minimizing disruption to the music streaming industry.

A. The Working Proposal Does Not Satisfy the Section 801(b)(1) Factors Without Significant Adjustment[16]

The methodology that the Judges outlined in the Working Proposal, absent adjustment, would fail to satisfy at least three of the four objectives set forth in Section 801(b)(1). Under Section 801(b)(1)(B), the mechanical royalty rate must afford "the copyright user a fair income under existing economic conditions." 17 U.S.C. § 801(b)(1)(B) (2006). The Working Proposal, however, assumes that the major record companies retain the Services' revenue up to the point that, in combination with the musical works royalty rates, would "deprive the interactive service sector of revenues sufficient to allow them to survive," and then calculates a musical works royalty rate based on the Services' "survival" margin and the percentage of revenue that the record companies demand in payment from the Services. Dec. 9 Order at 2-3. A rate-setting framework for mechanical royalties that—by design—would leave the Services (at most) with only whatever the record companies think is sufficient to allow them to survive is not consistent with the Copyright Act's mandate to set a rate that provides the Services with "a fair income under existing economic conditions." 17 U.S.C. § 801(b)(1)(B) (2006). As Professor Katz,

---

[15] More specifically, the Services have proposed that the Judges adopt the royalty rate levels and rate structure from the *Phonorecords II* settlement but update the *Phonorecords II* terms to include many of the other terms of the Final Determination, as amended during the implementation of the Music Modernization Act, that were upheld in the appeal of the Final Determination in *Johnson*, 969 F.3d at 367, 381, including terms relating to student and family plan products, or that were not challenged by either the Copyright Owners or the Services. *See* Services' Joint Written Direct Remand Submission at Tab C, eCRB Doc. No. 23856 (Apr. 1, 2021).

[16] This section responds to Question 4 in the January 6 Order.

Professor Marx, and Dr. Leonard each explain, the Services must retain more than their "survival" level to receive a fair income for the rate period at issue. *See* Katz WSRT ¶¶ 10-12; Marx WSSRT ¶ 20; Leonard WSSRT ¶ 10. The Services generate economic value for the Copyright Owners and sound recording rightsholders, which is clear from the fact that virtually all record companies have chosen to license their catalogs to the Services and from the fact that streaming is widely acknowledged as having saved the music industry. Katz WSRT ¶ 12. Thus, whether analyzed under a Shapley Value framework, any other notion of fairness, or an effective competition standard, the Services should receive positive income, *i.e.*, income *above* their "survival" rate, to compensate them for the economic value they generate. Katz WSRT ¶¶ 12-13; Marx WSSRT ¶¶ 20-21; Leonard WSSRT ¶¶ 10-12.

Under Section 801(b)(1)(C), the mechanical royalty rate must also "reflect the relative roles" of *both* "the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets." 17 U.S.C. § 801(b)(1)(C) (2006). In addition to failing to provide the Services with a "fair income under existing economic conditions," the Working Proposal also fails to adequately reflect the Services' relative role in establishing, sustaining, and growing the interactive streaming industry. It ignores the Services' manifold creative and technological contributions, their capital investments, and the considerable risks and costs they bore to create a thriving music streaming industry that reversed the fortunes of songwriters and music publishers who were negatively impacted by piracy and the disaggregation of the album. *See* Written Direct Testimony of Michael Katz ¶ 96 (Katz WDT) ("[T]here has been significant innovation by interactive music streaming services that is valuable to consumers and has helped stimulate music revenues and put a halt to the precipitous decline in music recording revenues that began in 2000."); Katz WSRT ¶ 12. Instead of compensating the Services for these contributions and their relative role in music streaming, the Working Proposal would leave the Services with the bare minimum that they need to survive and then split the rest—and thus any surplus generated by offering interactive streaming to consumers—between the Copyright Owners and the record companies. *See* Katz WSRT ¶¶ 7-9; Marx WSSRT ¶¶ 20-21; Leonard WSSRT ¶¶ 10-12. But this approach is at odds with the governing statute because Section 801(b)(1)(C) requires the Judges to balance the relative roles of the Copyright Owners and the *Services*—not the Copyright Owners and the *record companies*.

Even when taking the royalty burden that complementary oligopoly record companies impose on the Services as a given, the Working Proposal nonetheless embodies a *choice* by the Judges to place all of the impact of that burden—and the record companies' exercise of their market power—on the Services, and none of it on the Copyright Owners, who still receive the share of the surplus determined by the Shapley-inspired analysis underlying that proposal. There is no valid economic basis nor any statutory support for that choice. *See* Katz WSRT ¶ 7-9; Marx WSSRT ¶¶ 20-21; Leonard WSSRT ¶ 12. If the Judges wish to utilize a game-theoretical approach to rate-setting, rather than the benchmarking approach the Services' experts recommend, other approaches would still be far more consistent with Section 801(b)(1)(C). For example, one could take the royalties the record companies impose as a given and then divide the remaining revenues equitably between the Copyright Owners and the Services. This better serves the Section 801(b)(1)(C) factor than limiting the Services to only their survival rate, letting the Copyright Owners have 26.2% of what remains, and assuming the sound recording royalties will fall commensurately with any increase in musical works royalties, with no regard to the Services' and Copyright Owners' relative roles in the growth of the interactive streaming industry. *See* Written Direct Remand Testimony of Leslie Marx ¶¶ 59-63 (Marx WDRT) (suggesting "taking sound recording rates as given and allocating the remaining Service revenue to the Services and Publishers in such a way that each gets an equal share of the revenue that they are due under the Majority's fair allocation"); *see also* Dec. 9 Order at 3 n.5 (crediting Professor Marx's testimony on this point); *see infra* Section III.

Finally, the Working Proposal is inconsistent with the fourth Section 801(b)(1) factor because it sets the bar far too low for evaluating disruption. By basing the musical works royalty rate on the Services' "survival" rate, the Working Proposal implies that a rate will only be disruptive if it is so high that Services cannot survive and thus abandon the music streaming business. The Judges have not taken such a narrow view of disruption in the past, and they should not do so now. *See Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services* (*SDARS I*), Final Rule, 73 Fed. Reg. 4080, 4097 (Jan. 24, 2008) (lowering rates under the fourth Section 801(b)(1) factor not to avoid shutdown, but "[i]n order not to significantly delay the attainment and amounts of EBITDA profitability and positive free cash flow"); *see also Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services* (*SDARS II*), Final Rule, 78 Fed. Reg. 23,054, 23,069 (Apr. 17, 2013) (noting that the disruption factor called for a downward adjustment to rates when the services "were not sufficiently profitable"). Moreover, as discussed next, [redacted] (and cannot decline retroactively based on the outcome of this remand), the Working Proposal will result in combined royalties *above* the identified survival rate. That, by definition, is disruptive even under the most extreme interpretation of that statutory factor.

B. The Working Proposal Erroneously Assumes a 100% See-Saw Effect

After deducting the "survival" rate from service revenue, the Working Proposal divides the remainder between the Copyright Owners and the record companies according to a ratio derived from Professor Gans's "Shapley-inspired" model and adopted in the vacated *Phonorecords III* determination. But the percentage allocated to the record companies in this model is *not* the percentage that they have actually secured under their license agreements with the Services and that the Services actually have paid during the period. Dec. 9 Order at 3. Instead, it is merely the mathematical result of a predetermined formula whereby the Copyright Owners receive 26.2% of the amount the record companies receive, and the combined total theoretically leaves the Services with their "survival" share. *Id.* Thus, the Working Proposal necessarily assumes that, if the result of the formula is to increase the musical works royalty rate, the record companies will voluntarily adjust sound recording royalty rates downward by an amount that is equal to the increase in the musical works royalty rate such that the combined royalty payments remain the same and the Services will continue to survive. In other words, the Working Proposal assumes that the "see-saw" effect will occur and that decreases in sound recording royalties will be equal to 100% of any increase in the musical works royalty rate. *See* Katz WSRT ¶¶ 5-6; Marx WSSRT ¶ 21; Leonard WSSRT ¶¶ 5-7.

As the Services have previously explained, [redacted]. To the contrary, the record shows that [redacted]. Services' Opening Remand Br. at 44-50 (collecting fact and expert witness testimony). In fact, [redacted]

[redacted]. *Id.*; Services' Joint Supplemental Remand Br. at 4-5 (citing evidence); *see also* Katz WSRT ¶ 6; Marx WSSRT ¶ 22.

Further, even if the see-saw theory were sound, it could not work in this situation. Now that the *Phonorecords III* rate period is almost over, [redacted].[17] The Services have already paid their sound recording royalties for most of the rate period, and [redacted]. *See, e.g.*, Bonavia WDRT ¶¶ 17-19 ([redacted]); Written Direct Remand Testimony of George White ¶¶ 19, 27 (White WDRT) ([redacted]); Written Supplemental Remand Testimony of Jonathan Barnes ¶ 13 (Barnes WSRT) ([redacted]); Katz WSRT ¶ 6; Marx WSSRT ¶ 22; Leonard WSSRT ¶ 7. At this point, assuming a substantial see-saw effect during the relevant rate period—let alone a 100% see-saw effect—would be even more of a "heroic assumption" than it was when the now-vacated Final Determination was issued. *See Phono III*, 84 Fed. Reg. at 1966 (Dissent) (cleaned up). It would require assuming not only that record companies would forgo significant future income streams, but also that they would reimburse the Services millions of dollars that have already been paid. *See* Katz WSRT ¶ 3; Marx WSSRT ¶ 22; Leonard WSSRT ¶ 7. Such an assumption is totally implausible.

---

[17] Even at the earlier stage of this proceeding in 2018, no expert suggested the see-saw rate would be 100% as the Working Proposal implies. *See* Katz WSRT ¶ 6; Marx WSSRT ¶ 22.

Because the Working Proposal, by its own logic, depends on the assumption that any increase in the musical works royalty rate will be completely offset by an equal decrease in sound recording royalty rates (thus maintaining the "survival" rate), the Services will, as a matter of simple math, inevitably receive *less* than their "survival" rate if the Judges apply the Working Proposal in its current form to increase the musical works royalty rate. *See* Katz WSRT ¶¶ 3, 8, 23; Marx WSSRT ¶¶ 21-22; Leonard WSSRT ¶¶ 5-7. The Services will pay the increased musical works royalty rates to the Copyright Owners and [redacted]. *See* Katz WSRT ¶¶ 3, 8, 23; Marx WSSRT ¶ 21; Leonard WSSRT ¶ 7. For example, if the Judges adopt the "survival" rate that the Services offer above—a total headline royalty rate of [redacted]% of revenue—the Working Proposal yields an all-in musical works rate of [redacted]%. *See supra* Section I. Assuming the record companies refuse to lower [redacted] sound recording rates below their current level of [redacted], then [redacted] would pay total royalties of [redacted]% of its revenue ([redacted]% + [redacted]% = [redacted]%)—significantly more than the [redacted]% rate that the Working Proposal assumes would allow [redacted] to survive. The Working Proposal thus undermines the very goal it is meant to achieve: it fails to afford the Services even their "survival" rate.

C. The Working Proposal Does Not Adequately Address or Remedy the Record Companies' Complementary Oligopoly Power[18]

As both the D.C. Circuit and the Judges have acknowledged, "sound recording rightsholders have considerable market power vis-à-vis interactive streaming service providers, and they have leveraged that power to extract excessive royalties." *Johnson*, 969 F.3d at 382; *accord* Dec. 9 Order at 2 ("The Judges have found that the major record companies, Sony Music

[18] This section responds to Question 1(a) in the January 6 Order.

Entertainment, Warner Music Group and Universal Music Group (collectively, the Majors) are unregulated complementary oligopolists.”). While the Working Proposal professes to take the rates charged by the record companies as a given, the Judges’ explanation in the December 9 Order suggests that the Working Proposal (and the sections of the vacated *Phonorecords III* determination from which the Working Proposal draws the 26.2% TCC ratio) adequately accounts for (and possibly even mitigates) the record companies’ complementary oligopoly power. Dec. 9 Order at 2-3. It does not.

Recognizing (and even accepting) that the record companies will use their “considerable market power” to extract excessive royalties, *Johnson*, 969 F.3d at 382, the Judges could respond, as noted above, by dividing the remaining revenues fairly between the Services and the Copyright Owners. *See supra* Section II.A. Instead, the Working Proposal places the entire burden of the record companies’ complementary oligopoly power on the Services by giving the Copyright Owners their full share of the revenue generated by the Judges’ Shapley-inspired analysis, while giving the Services far less than their share dictated by that same analysis. *See id.*

Furthermore, [redacted], the Working Proposal does not mitigate the impact of the record companies’ complementary oligopoly power at all. Rather, sound recording royalty rates will remain at their current levels, musical works royalties will increase and, as discussed above, [redacted]. *See* Katz WSRT ¶¶ 3, 8, 23; Marx WSSRT ¶ 21; Leonard WSSRT ¶¶ 5-7. An approach that saddles only the Services and not the Copyright Owners with the full burden of the record companies’ complementary oligopoly power would not assure that the Services receive a "fair income" for their contributions, reflect their relative roles in the music streaming industry, or avoid disruption under Section 801(b)(1). *See supra* Section II.A.

III. THE WORKING PROPOSAL SHOULD BE MODIFIED SO THAT, IF THE JUDGES RELY ON IT, THE RESULTING RATES BETTER SATISFY THE GOVERNING STANDARD[19]

While the rate-setting formula in the Working Proposal suffers from the fundamental problems described in the preceding section, there are adjustments to the methodology that would result in rates that better satisfy the governing rate-setting standard. Professor Marx and Dr. Leonard provide adjustments that should be made to improve the Working Proposal and move the resulting rates in the direction indicated by the Section 801(b)(1) factors. Marx WSSRT ¶¶ 23-36; Leonard WSSRT ¶¶ 23-26.

Professor Marx and Dr. Leonard first propose a series of adjustments to convert the rates emerging from the Working Proposal from market power-influenced rates into rates that more closely resemble those that would emerge in a workably competitive market. As noted in the December 9 Order, "the Judges might determine that the appropriate method and formula for setting an 'effectively competitive,' 'reasonable' and/or 'fair' mechanical royalty" is to use the rate-setting formula from the Working Proposal. Dec. 9 Order at 3. But if the Judges are attempting to calculate an effectively competitive rate (or a "reasonable" or "fair" rate), the rate-setting formula in the Working Proposal cannot be used without adjustment. As discussed above, that formula assumes that the major labels will take full advantage of their complementary oligopoly power and dictate the amount that the Services retain, leaving them with enough to survive, but nothing more. Such an approach cannot be squared with any notion of effective competition. Katz WSRT ¶¶ 10-13; Marx WSSRT ¶ 30; Leonard WSSRT ¶¶ 10-12,

---

[19] This section responds to Question 3 (in part) in the January 6 Order.

23-26. To address this fundamental problem with the Judges' Working Proposal, Professor Marx and Dr. Leonard explain that two adjustments should be made.

First, the complementary oligopoly sound recording rate used in the rate-setting formula should be reduced by applying an "effective competition" adjustment. The Judges in *Web IV* and, more recently in *Web V*, made such an adjustment [redacted]. *See, e.g.*, *Web V* at 66-72; *see also* Corrected Written Rebuttal Testimony of Michael Katz ¶¶ 80-83 (Katz CWRT). While there is good reason to believe that such an adjustment is not sufficient, absent better evidence for how to make such an adjustment, that same approach can be used here. Marx WSSRT ¶ 32.

Second, the ratio used to divide the total royalty between the sound recording and musical works rightsholders should be replaced with a real-world ratio in which both the numerator and the denominator contain rates that approximate those that would emerge in an effectively competitive market. This second adjustment can be made by looking to the real-world ratios already in the record. For example, the Judges have previously found that the [redacted] sound recording to musical works royalty ratio based on the [redacted] is a "useful guidepost" for setting interactive streaming royalties. Final Det. at 51; Marx WSSRT ¶ 33; Leonard WSSRT ¶¶ 23-24.

This ratio is particularly appropriate for setting an effectively competitive rate because both the numerator and denominator rates are constrained by regulatory bodies charged with setting effectively competitive rates. Marx WSSRT ¶ 34; Leonard WSSRT ¶ 24. The sound recording rates in the non-interactive streaming market are set by the Judges under the willing buyer / willing seller standard—a standard that the Judges have consistently concluded calls for setting effectively competitive rates. *See, e.g.*, *Web V* at 6-7. The bulk of the musical works royalties for non-interactive streaming services are similarly constrained, as they are determined in negotiations with ASCAP and BMI, with the rate courts serving as a backstop to determine a "reasonable" fee. The rate courts have consistently interpreted this "reasonable" fee standard as one that calls for rates that would emerge in a negotiation between a willing buyer and a willing seller in a competitive market. *United States v. ASCAP* (*In re Applications of RealNetworks, Inc.*), 627 F.3d 64, 76 (2d Cir. 2010) ("Fundamental to the concept of 'reasonableness' is a determination of what an applicant would pay in a competitive market . . . ."); *United States v. ASCAP* (*In re Application of Buffalo Broad. Co.*), No. 13-95 (WCC), 1993 WL 60687, at *16 (S.D.N.Y. Mar. 1, 1993) ("[T]he rate court must concern itself principally with defining a rate . . . that approximates the rates that would be set in a competitive market." (citation omitted)), *aff'd in part and vacated in part on other grounds*, 157 F.R.D. 173 (S.D.N.Y. 1994).

When the Judges' rate-setting formula is modified to make these two adjustments, the resulting all-in musical works rate falls between [redacted]% and [redacted]%—rates that are in line with those contained in the *Phonorecords II* agreement—an agreement that, for the reasons the Services have articulated, should be used as a benchmark for rate-setting here. Marx WSSRT ¶ 36 & fig.4; Leonard WSSRT ¶¶ 27-30.

As an alternative, the Judges could instead look to the ratio of sound recording to musical works rates recently agreed to by the Copyright Owners and the record labels. In early March 2021, shortly after the *Phonorecords IV* proceedings commenced, the Copyright Owners and record companies reached a settlement to yet again continue the existing mechanical royalty rates and terms for CDs, permanent digital downloads, ringtones, and music bundles, which are currently addressed in Subpart B of 37 C.F.R.§ 385, through the year 2027. Notice of Settlement in Principle, *In re Determination of Royalty Rates and Terms for Making and Distributing*

Phonorecords (*Phono IV*), No. 21-CRB-0001-PR (2023-2027) (Mar. 2, 2021). If the Board adopts that settlement, the record labels will continue to pay the Copyright Owners the greater of $0.091 per track or $0.0175 per minute of playing time. *See* 37 C.F.R. § 385.11 (2019). As the Judges concluded in the Final Determination, that settlement implies a sound recording to musical works ratio of approximately [redacted] at the then-prevailing prices. Final Det. at 61 (noting that the former "subpart A settlement reflects a payment of [redacted]% of sound recording royalties" or a ratio of [redacted]). That ratio, repeatedly accepted by the Copyright Owners in direct, voluntary dealings with record labels, and one that the Majority found to be "useful," *Phono III*, 84 Fed Reg. at 1947, was most recently negotiated against the backstop of the *Phonorecords IV* proceeding, which is governed by the willing buyer / willing seller standard calling for effectively competitive rates. When this ratio is used, the resulting royalty rates are *well below* the *Phonorecords II* 10.5% headline rate, further confirming the reasonableness of the Services' Proposal. Marx WSSRT ¶ 36 & n.48; Leonard WSSRT ¶ 25.

Professor Marx also offers a second approach to partially address some of the other problems with the Judges' new rate-setting methodology. In this second alternative approach, she proposes making an adjustment so that the Services receive at least some reward for their relative contributions and come closer to earning a "fair" income. Without an adjustment along the lines proposed by Professor Marx (or use of the *Phonorecords II* benchmark instead of the Working Proposal as Professor Marx, Professor Katz, and Dr. Leonard all recommend), the Services will be left with something *less* than their survival rate—a result that is clearly at odds with the rate-setting standard. Marx WSSRT ¶ 28; Leonard WSSRT ¶ 14; Katz WSRT ¶ 24. To refine the rate-setting formula in the Working Proposal, Professor Marx begins with the sound recording portion of the total royalty rate that is used as the input to the Working Proposal, and holds that rate constant. As Professor Marx explains, it is appropriate to hold the sound recording rate constant because, among other reasons, the sound recording royalties over the *Phonorecords III* period have not only been set but largely been incurred and paid for—there is no mechanism by which these rates can be adjusted retroactively. Marx WSSRT ¶¶ 22, 29; *see also* Leonard WSSRT ¶¶ 13-14; Katz WSRT ¶ 6.

The amount that is left over after the labels take their cut is then split between the Copyright Owners and the Services. This allocation is done not by using the Judges' new rate-setting formula which, by design, will leave the Services with just their survival rate (and inevitably less than that when the sound recording rates do not decrease in response to the newly set musical works rate), but instead in a more balanced way—one that rewards both the Copyright Owners and the Services and better reflects their relative roles, as the governing statute requires.[20]

To do so, Professor Marx looks to the results of the model that the Majority used in the Final Determination. That model called for the Copyright Owners to receive 15.1% of revenue and for the Services to receive [redacted]% of revenue (the amount that is left over after paying a total royalty of [redacted]%). Final Det. at 75, 87 ("The Judges have determined a rate that is computed based on the highest value of overall royalties [[redacted]%] predicted by Professor Marx's model."). Because all of the plausible sound recording rate inputs to the Judges' new rate-setting formula are far higher than what the Majority's model concluded the sound recording rightsholders should receive, it is not possible to leave the Services and the Copyright Owners with the full

[20] Consistent with the Section 801(b)(1) factors, this variation on the Judges' Working Proposal focuses on splitting the available surplus between the Copyright Owners and the Services. In contrast, the Working Proposal focuses on splitting the available surplus between the record labels and the Copyright Owners.

amount the Majority's model determined they should each get. Instead, the amount that is left over after the record labels take their cut can be divided up proportionately, with the Services keeping [redacted] or about [redacted]% of the remaining revenue and the Copyright Owners getting [redacted] or about [redacted]% of the remaining revenue—the same proportions found in the Majority's rate-setting model. This approach takes the sound recording rates as a given, Dec. 9 Order at 3 n.5, and then more equitably splits what is left over between the Services and the Copyright Owners—as the Section 801(b)(1) factors require. Marx WSSRT ¶¶ 25-29; *see also* Katz WSRT ¶¶ 8-9; Leonard WSSRT ¶ 14.

Implementing this analysis yields rates that are lower than those that result from the Judges' new rate-setting approach. Rather than a range of musical works rates that span from [redacted]% to [redacted]%, when the burden imposed by the major record labels is more equitably shared between the Copyright Owners and the Services, the resulting rates range from [redacted]% to [redacted]%. Marx WSSRT ¶ 29 & fig.3. These rates better satisfy the governing rate-setting standard and are more in line with the rates found in the *Phonorecords II* benchmark. In fact, they are right in between the 10.5% *Phonorecords II* headline rate and the effective rate paid by [redacted] under the *Phonorecords II* settlement. Dissent at 115-16, *Phono III*, No. 16-CRB-0003-PR (2018-2022) (Nov. 5, 2018) (noting that [redacted]).

IV. ELIMINATING THE TCC PRONG IS APPROPRIATE IF THE JUDGES ADOPT A VERSION OF THE WORKING PROPOSAL[21]

The Services submit that retaining an alternative TCC prong in a "greater of" structure is at odds with the Working Proposal's economic approach, and the Judges' proposal to discard the TCC prong if they adopt that approach is warranted.

First, as both the D.C. Circuit and the Judges have recognized, the TCC prong "yokes the mechanical license royalties to the sound recording rightsholders' unchecked market power," especially when the caps on the TCC prong are removed. *See Johnson*, 969 F.3d at 382; *accord* Jan. 6 Order at 11. By eliminating the TCC prong from the rate structure, the Judges would prevent the musical works royalty rates from arbitrarily increasing—potentially above the identified "survival" level—every time the sound recording rightsholders exercise their complementary oligopoly power to extract higher royalty rates. *See Phono III*, 84 Fed. Reg. at 1964 (Dissent) ("[W]henever the record companies demand and obtain a higher sound recording royalty rate"—which they can through their "economic power to demand rates that embody their 'complementary oligopoly' status"—the "mechanical royalty rate *must increase as well*."). For reasons discussed above, such arbitrary increases in musical works royalty rates would deny the Services a "fair income," would fail to reflect their relative roles in the streaming industry, and would be highly disruptive to the Services' businesses. *See Johnson*, 969 F.3d at 382 (explaining that, "by virtue of their oligopoly power, the sound recording copyright holders have extracted 'inflated' royalties relative to what the Shapley Analyses would predict"). Thus, eliminating the TCC prong would better comport with the requirements of Section 801(b)(1).[22]

---

[21] This section responds to Questions 1(c), 1(d), 2, and 3 (in part) in the January 6 Order.

[22] As Professor Marx explains, there is no need to maintain the TCC prong to protect against revenue deferral or diminution concerns. Marx WSSRT ¶ 38.

Second, adding a TCC prong would violate the very premise of the Working Proposal itself. The Working Proposal arises from the Majority's conclusion in the Final Determination that musical works owners should receive 26.2% of the royalties that the Services pay to sound recording rightsholders. *Phono III*, 84 Fed. Reg. at 1918. Although the Services disagree with the Majority's analysis and assumptions, the Majority's approach—working from that TCC percentage—was intended to identify the industry-wide effective percentage of revenue that the Services should pay to musical works owners according to a Shapley-style analysis, rather than a headline rate. Katz WSRT ¶ 14. In other words, it was *not* intended to be the percentage-of-revenue rate in a multi-pronged rate structure with a TCC prong and mechanical floors where that percentage-of-revenue rate might not bind. *Id.* Indeed, if a percentage-of-revenue rate derived from that analysis were paired in a greater-of structure with a TCC prong, the resulting industry-wide effective rate inevitably would be *higher* than the rate that the Working Proposal was intended to produce to the extent it resulted in some services paying royalties under the TCC prong. *Id.* For all the reasons above, such a result would deny the Services a "fair income" for their contributions, would fail to reflect the Services' relative roles in the music streaming industry, and would be disruptive to the streaming industry. 17 U.S.C. § 801(b)(1)(B)-(D) (2006).[23]

[23] If the Judges nonetheless were to adopt a rate structure that incorporated an alternative TCC prong—or any other alternatives to the percentage of revenue, including mechanical floors—it would be economically warranted to make a downward adjustment to the percentage-of-revenue rate to offset those cases in which the TCC prong or other alternative rate pushed the industry-wide average above the effective rate that the Working Proposal was meant to produce. Katz WSRT ¶¶ 14-16. Given the complexities of calculating such an adjustment, the far simpler approach would simply be to remove the TCC prong and the mechanical floors and adopt a single percentage-of-revenue rate that applies across the board. *See id.*

Third, eliminating the TCC prong would help ameliorate the flaws in the Working Proposal (albeit incompletely). As discussed above, the Working Proposal assumes that a 100% see-saw effect will offset any increases in the musical works royalty rate. [redacted]. *See supra* Section II.B. Thus, to the extent that the Judges increase the musical works royalty rates, [redacted]. *See supra* Sections II.A-B. Removing the TCC prong (and, for that matter, other alternative rate prongs such as the mechanical floors) would help to lessen the adverse effects of any increased musical works rate by assuring that the Services are not forced to pay *even higher* rates, leaving them with even *less* than the Working Proposal indicates is necessary for their survival.

V. THE SERVICES' PROPOSAL REMAINS PREFERABLE TO THE WORKING PROPOSAL[24]

Though the Judges have the authority to consider a new method of setting rates, such as the Judges' Working Proposal, the Judges cannot overlook the D.C. Circuit's direction to reevaluate the *Phonorecords II* settlement as a benchmark. *Johnson*, 969 F.3d at 387. Nothing in the remand proceeding has demonstrated that *Phonorecords II* agreement is an unreliable benchmark or provided the Judges with a reason to reject that benchmark. And adoption of the *Phonorecords II* benchmark along the lines proposed by the Services remains the most sound approach, especially in light of the flaws in the Judges' working proposal identified above.

[24] This section responds to Questions 1(b), 2, and 3 (in part) in the January 6 Order.

A. A Reliable Benchmark Obviates the Need for Theoretical Modelling

The benchmark approach is "a hallmark of the sound recording and musical works rate proceedings." *Distribution of Cable Royalty Funds*, Final Rule, 84 Fed. Reg. 3552, 3602 (February 12, 2019). The approach is favored because "there is a presumption that marketplace benchmarks demonstrate how parties to the underlying agreements commit real funds and resources, which serve as strong indicators of their understanding of the market." *Determination of Royalty Rates and Terms for Ephemeral Recording and Webcasting Digital Performance of Sound Recordings* (*Web IV*), Final Rule, 81 Fed. Reg. 26,316, 26,327 (May 2, 2016). In past proceedings, the Board has explained that where "the Judges have sufficient confidence in the available benchmark analyses," they will "proceed without reference to other guideposts," including theoretical models. *Id*. at 26,391. The Board also explained that in those instances where the Board has looked beyond real-world benchmarks for its analysis, such as in the *SDARS II* proceeding, it was only because "the Judges had little confidence in the benchmark analyses offered by the parties." *Id*.

The Judges' past preference for using benchmarks over purely theoretical models is economically rational. As Dr. Leonard explained in this remand, theoretical models that purport to predict real-world outcomes (even ones that appear theoretically sound) can badly miss the mark, which is why economists in recent decades have moved away from relying on purely theoretical models that are not paired with credible empirical analysis. Leonard WSRT ¶¶ 23-25; Leonard WDRT ¶¶ 17-22. Put simply, using a benchmark, like *Phonorecords II*, avoids many of the pitfalls and inherent inconsistencies that come with employing an assumption-laden model to a real-world marketplace that demonstrably does not fit that model.

B. The *Phonorecords II* Settlement Is an Unquestionably Reliable Benchmark

This Board has previously explained that its evaluation of a benchmark turns on "whether [the benchmark] has the same buyers and sellers as the target market and whether they are negotiating for the same rights." *Determination of Royalty Rates and Terms for Transmission of Sound Recordings by Satellite Radio and "Preexisting" Subscription Services* (*SDARS III*), Final Rule, 83 Fed. Reg. 65,210, 65,214 (Dec. 19, 2018). Here, the *Phonorecords II* settlement meets all of these criteria: it involves the same sellers, the same or similar buyers, and the same rights that are issue in this proceeding. *See* 3/15/17 Tr. 1082:11-1083:16 (Leonard); 3/13/17 Tr. 550:20-551:19, 566:23-567:25 (Katz); Ex. 885 ¶ 71 (Katz WDT); *see also Phono III*, 84 Fed. Reg. at 1999 (Dissent) ("[T]he licensors (music publishers) and licensees (interactive streaming services) categories are comparable (if not identical)."). It is for these reasons that Judge Strickler observed that the *Phonorecords II* settlement has the "classic characteristics of an appropriate benchmark." *Phono III*, 84 Fed. Reg. at 1999 (Dissent).

As the D.C. Circuit noted, the Majority did not provide a valid, rational reason for its choice not to follow the *Phonorecords II* benchmark. *Johnson*, 969 F.3d at 387. What is more, the Majority did not fully reject the benchmark; rather, it adopted the benchmark for certain purposes while ignoring it for others. For instance, the Majority retained the exact floor fees from *Phonorecords II*, retained the different service categorizations, and even retained the basic "greater of" structure that compares a percentage of revenue against TCC. *Phono III*, 84 Fed. Reg. at 2031-36; *see also Adjustment of Determination of Compulsory License Rates for Mechanical and Digital Phonorecords* (*Phono II*), Final Rule, 78 Fed. Reg. 67,939, 67,942-51

(Nov. 13, 2013).[25] Judge Strickler went further and advocated for wholesale adoption of the benchmark. *Phono III*, 84 Fed. Reg. at 2013-14 at 2013-14 (Dissent) (discussing reasons for carrying over the *Phonorecords II* rates). And recent Orders suggest that the Judges intend to carry over certain aspects of *Phonorecords II* in the outcome of this remand. *See* Dec. 9 Order at 4 (observing that the mechanical floors the parties agreed to in the *Phonorecords II* settlement would remain in effect). The Judges have evinced a clear belief that *Phonorecords II* is a useful benchmark for multiple purposes, and neither the Judges nor the Copyright Owners have provided a valid rationale for not adopting the benchmark in its entirety.[26] *See* Services' Joint Opening Remand Br. at 34-44 (explaining that Copyright Owners' criticisms of the benchmark each fail); Services' Joint Reply Remand Brief at 19-33 (same).

Indeed, even the principles behind the Judges' recent Working Proposal point towards adoption of the *Phonorecords II* benchmark. As discussed above, the most appropriate total royalty input into the Working Proposal (prior to making necessary adjustments) includes as one

---

[25] In the January 6 Order, the Judges have asked the parties to identify the offerings that had mechanical-only floors and uncapped TCC prongs under the *Phonorecords II* rate structure. Jan. 6 Order at 5 n.9. The offerings under the *Phonorecords II* regulations that had mechanical-only floors were "standalone non-portable subscriptions," "standalone portable subscriptions," and "bundled subscription services." 37 C.F.R. § 385.13(a) (2014) (cleaned up); *see also* Order Granting in Part and Denying in Part Motions for Rehearing (Amended) at 12-13, *Phono III*, No. 16-CRB-0003-PR (2018-2022), eCRB Doc. No. 3602 (Jan. 4, 2019) (Rehearing Order) (explaining that "[t]he existing minimum" for paid locker services and limited offerings "was not a mechanical floor"). And the "standalone non-portable subscription" and "standalone portable subscription" offerings had capped TCC prongs. 37 C.F.R. § 385.13(a) (cleaned up). The remaining then-Subpart-B and -C offerings had uncapped TCC prongs. *Id.* §§ 385.13(a), 385.23(a).

[26] Specifically, the Services propose to continue the rate levels and full structure of *Phonorecords II* with one notable change. Consistent with the Final Determination and as affirmed by the D.C. Circuit, the Services propose to treat family plans as having 1.5 subscribers and student plans as having 0.5 subscribers for purposes of any per-subscriber calculations, such as for mechanical-only floors and for TCC caps.

component the musical works rates that were in place at the time the major labels negotiated with [redacted]. Those rates were the *Phonorecords II* rates. And, given that there is [redacted], for the reasons already discussed, were the Judges to raise rates above the *Phonorecords II* level, they would almost certainly leave the Services with something less than their survival rate because [redacted]. Under these circumstances—and given the Judges' expressed intent to leave the Services with at least their survival rate—even the Judges' Working Proposal counsels in favor of maintaining the *Phonorecords II* rate levels.

Moreover, as the Services have previously explained, adoption of the *Phonorecords II* benchmark comports with each of the four Section 801(b) policy factors. *See* Services' Joint Opening Remand Br. at 24-30 (analyzing the benchmark with regard to each 801(b) factor). Indeed, the settlement was the product of an industry-wide negotiation that occurred against the backdrop of Section 801(b)(1), and thus it already represents the parties' view of a fair outcome at the time. *See Phono III*, 84 Fed. Reg. at 1993 (Dissent) (industrywide settlements "may be evidence of a rate that is fair and thus consonant with Factor B of section 801(b)(1)"); *see also* Ex. 6016 (Motion to Adopt Settlement, *Phono II*, No. 2011-3 CRB (Apr. 10, 2012)) (Copyright Owners representing to the Board that "nothing in the Settlement is contrary to the provisions of the applicable statutory license or otherwise contrary to law" and "there is no basis for the Judges not to adopt the Settlement."). The settlement's rates and structure also have worked well in practice—with a tremendous period of industry growth and corresponding increases in mechanical royalty payments occurring while those rates were in place. *See e.g.*, Written Direct Testimony of Leslie M. Marx, PhD, Appendix B at B-1 to B-4; Services' Joint Proposed Findings of Fact ¶¶ 89-108; *see also Phono III*, 84 Fed. Reg. at 1991-92 (Dissent). And the rates contained in the settlement are corroborated by other real-world benchmarks, including direct license agreements and the "Subpart A" settlements, which the Copyright Owners and the sound recording companies have agreed to yet again in *Phonorecords IV*. Services' Joint Opening Remand Br. at 30-34.[27] All these factors suggest that there is no need to substantially amend *Phonorecords II* or alter the rates contained within the *Phonorecords II* structure.[28]

C. If the Judges Adopt the Services' Proposal and the *Phonorecords II* Rates, the TCC Prong May Be Retained[29]

As discussed above, removing the TCC prong is rational and fair if the Judges adopt some version of the Working Proposal. However, if the Judges instead adopt the *Phonorecords II* benchmark for purposes of both rate levels and structure, as the Services have proposed, then removing the TCC prong is more complicated. As the record makes clear, the *Phonorecords II* framework reflects a carefully negotiated set of tradeoffs, including TCC (with certain caps), against a headline rate of 10.5% of revenue, and should thus be evaluated in its entirety. *See Phono III*, 84 Fed. Reg. at 1996-99 (Dissent).

Additionally, removal of TCC from the *Phonorecords II* structure could have unintended consequences that would not impact all services the same way (*i.e.*, if TCC is removed but the per-subscriber minima are retained as an alternative to the headline percentage-of-revenue, some services may actually pay *more* in the absence of TCC given that it could push services into

---

[27] The rates and terms for permanent digital downloads that formed the "Subpart A" settlement are now codified under subpart B of the regulations.

[28] As noted above, the Services do propose to treat family plans as having 1.5 subscribers and student plans as having 0.5 subscribers for purposes of any per-subscriber calculations, as was upheld by the D.C. Circuit. Unlike other potential changes to the *Phonorecords II* benchmark that are under discussion, this change addresses a product feature (discounted family and student plans) that was not prevalent in the industry at the time of the settlement.

[29] This section responds to Question 2 in the January 6 Order.

paying the per-subscriber minimum, which is currently the cap in the "lesser-of" formulation, instead). In theory, adjustments could be made to the headline rates to account for such effects, but such adjustments, when applied on an industry-wide basis, could result in uncertain and inconsistent application to different services and/or service tiers. As the Services have made clear above, adopting the *Phonorecords II* benchmark without substantial adjustment to the rates or structure contained therein is the simplest and most reliable way to arrive at an outcome in this proceeding without resorting to theoretical guesswork.

VI. THIS REMAND PROCEEDING IS NEW AGENCY ACTION, BUT THE JUDGES NONETHELESS HAVE NO LEGAL BASIS TO ALTER THE SERVICE REVENUE DEFINITION

A. This Remand Proceeding Is New Agency Action

The Services and Copyright Owners agree that this remand proceeding qualifies as "new agency action" under *DHS v. Regents of the University of California*, 140 S. Ct. 1891, 1907-08 (2020).[30] The Services agree that the Judges have provided the parties with sufficient procedural opportunities to raise any additional arguments regarding the question the D.C. Circuit remanded: the source of "any legal authority for adopting the new Service Revenue definition" in place of the definition included in the Initial Determination. *Johnson*, 969 F.3d at 389, 392. Accordingly, the Judges are not procedurally confined to offering only a "fuller explanation" of their previous reasoning for revisiting the definition in the Rehearing Order, *see* Rehearing Order at 2 & n.3, and may offer new reasons supporting any legal authority to alter the Initial Determination's Service Revenue definition. The Services also agree that, if the Judges were to

---

[30] *Compare* Copyright Owners' Mot. for Reconsideration or Clarification at 16, No. 16-CRB-0003-PR (2018-2022) (Remand), eCRB Doc. No. 25979 (Dec. 17, 2021), *with* Services' Joint Reply Remand Br. at 53-54, *Phono III*, No. 16-CRB-0003-PR (2018-2022) (Remand), eCRB Doc. No. 25426 (July 2, 2021).

identify such legal authority, the Judges have provided the participants with adequate procedural opportunities to present any new evidence on the proper Service Revenue definition for bundles.

B. The Judges May Not Alter the Service Revenue Definition Without First Identifying Legal Authority in the Copyright Act for Modifying the Initial Determination and No Such Legal Authority Exists

The participants' dispute regarding the Service Revenue definition issue does not turn on whether this remand is "new agency action," but rather on whether, by taking new agency action, the Judges may bypass the question the D.C. Circuit remanded: the source of the Judges' authority for altering the Service Revenue definition in the Initial Determination. The Copyright Owners say that, because this proceeding is new agency action, the Judges need never respond to the threshold legal error the D.C. Circuit identified, and may simply move on to reconsidering the Service Revenue definition. *See* Copyright Owners' Motion for Reconsideration or Clarification at 16, No. 16-CRB-0003-PR (2018-2022) (Remand) (Dec. 17, 2021) ("[T]he law is clear that this Remand proceeding is unquestionably a 'new agency action' which allows adoption of a Service Revenue definition without limitation to the definition expressed in the Initial Determination."). That is incorrect. The Judges must respond to the court's mandate, and the Judges may not ignore on remand the limits that the Copyright Act places on the Judges' authority to alter an Initial Determination.

The scope of this new agency action is bound by the question the D.C. Circuit remanded. The D.C. Circuit set out that question at the outset of its discussion of the Service Revenue definition for bundled offerings: "Because the Board failed to explain the legal authority for its late-breaking rewrite, we vacate and remand that aspect of the decision." *Johnson*, 969 F.3d at 389; *see id.* ("The problem is that the Board has completely failed to explain under what authority it was able to materially rework that definition so late in the game."). And it did so at the end of the discussion, explaining that, "[b]ecause the Board failed to identify any legal authority for adopting the new Service Revenue definition," the court "must vacate the Final Determination's bundled offering Service Revenue definition and remand." *Id.* at 392.[31]

The court explained that, on remand, the Judges could "either . . . provide a fuller explanation . . . or . . . take new agency action." *Id.* (quotation marks omitted) (quoting *Regents*, 140 S. Ct. at 1908). The either/or framing of the task on remand confirms that—whichever path the Judges take—the Judges must answer the actual remanded question, and only then, if the Judges have the authority to change it, move on to the substantive question of what the Service Revenue definition should be. Taking new agency action means the Judges are not limited to offering additional explanation for the reasoning relied on in the Rehearing Order, and instead may offer new reasons why the Copyright Act authorizes the Judges to change the definition in the Initial Determination. *See Regents*, 140 S. Ct. at 1908; *Fisher v. Pension Benefit Guar. Corp.*, 994 F.3d 664, 670 (D.C. Cir. 2021). But even under the new agency action procedural route, the Judges must still respond to the court's mandate and answer *that* question. *See Bean Dredging, LLC v. United States*, 773 F. Supp. 2d 63, 78 (D.D.C. 2011); *see also Ali v. Pompeo*, No. 16-CV-3691-SJB, 2020 WL 6435834, at *4-5 (E.D.N.Y. Nov. 2, 2020) (enforcing the mandate rule in a case in which the agency, on remand, engaged in "new agency action"). Taking "new agency action" does not (as the Copyright Owners assert) give the Judges authority to jump to reexamining the substance of the Service Revenue definition without first identifying their legal authority to substantively change the Initial Determination's definition. The Copyright Owners have cited no case suggesting—much less holding—that taking new agency action enables an agency to avoid the mandate rule.

[31] Indeed, because the D.C. Circuit found an error at that threshold issue, it "ha[d] no occasion to address the Streaming Services' separate argument that the [new] definition was arbitrary, capricious, or unsupported by substantial evidence." *Johnson*, 969 F.3d at 392.

The Copyright Owners' position also would effectively nullify the express limits that Congress put on the Judges' ability to alter an Initial Determination. The Copyright Act gives the Judges power to alter an Initial Determination only in limited, technical ways, except in "exceptional cases" where rehearing is warranted. *See Johnson*, 969 F.3d at 390 ("Section 803 identifies three ways in which the Board can revise Initial Determinations."). Those statutory limits would be meaningless if—following a vacatur and remand because a court found the Judges had exceeded those limits—the Judges were free to modify an Initial Determination without regard to those limits. The Copyright Owners have also never attempted to reconcile their position with the Copyright Act's clear limits on the Judges' authority to modify Initial Determinations.

For these reasons, the Judges must adhere to the Service Revenue definition for bundled offerings in the Initial Determination unless they can first identify legal authority that "fit[s] []one of th[e] categories" in Section 803. *Id.* And as the Services have explained, no such authority can be identified. First, the Judges may not now invoke their rehearing authority under § 803(c)(2)(A). The D.C. Circuit already found that this change "does not fall within the Board's rehearing authority," relying on the Judges' own prior, correct, and unappealed finding that the "Copyright Owners' motion did not meet the exceptional standard for granting rehearing motions." *Id.* (citation omitted). Second, the Judges also may not invoke the authority under § 803(c)(4) to correct technical or clerical errors. The Judges previously and correctly "admit[ted] that the new definition . . . was a substantive" change, and the D.C. Circuit agreed there was "[n]othing technical or clerical about" it. *Id.* at 390-91. Third, the Judges may not invoke the other authority under § 803(c)(4), which permits corrections of "terms, but not the rates," in "response to unforeseen circumstances." *Id.* at 390. There are no circumstances that the Judges could identify that would qualify as "unforeseen" within the meaning of this provision as the D.C. Circuit interpreted it. *See id.* at 391. Finally, the D.C. Circuit rejected the notion that the Judges have "the inherent authority *sua sponte* to make any appropriate substantive or fundamental changes after the Initial Determination" outside of the limits in Section 803. *Id.* (cleaned up). There are no other sources of authority. The Copyright Owners have never attempted to identify one, nor have they explained how the Judges could rely on one of the three sources of authority in Section 803 in a manner that would be consistent with *Johnson*. Unable to pass this threshold legal question remanded by *Johnson*, the Judges must retain the Initial Determination's Service Revenue definition for bundled offerings.[32]

CONCLUSION

For these reasons, the Judges should rely on the *Phonorecords II* settlement as a benchmark and adopt the Services' Proposal. But if the Judges instead rely on the methodology set forth in the Working Proposal, they should use the input the Services have identified above as well as the adjustments needed to ensure that the formula can yield rate levels that satisfy all four Section 801(b) factors. As explained above, the input and modifications result in all-in musical works rate that falls between [redacted]% and [redacted]% of revenue and that should not be combined with an alternative TCC prong.

---

[32] The Services have also explained that, even if the Judges could identify a provision in Section 803 that answers the remanded question in *Johnson* and permits the Judges to modify the Initial Determination's Service Revenue definition for bundled offerings, the Judges should—on the merits—retain that definition. Because the Judges have not requested additional briefing on that issue, the Services refer the Judges to their prior briefing on that point. *See* Services' Joint Opening Remand Br. at 68-76; Services' Joint Reply Remand Br. at 57-62.

January 24, 2022

Respectfully submitted,

/s/ Kenneth L. Steinthal
Kenneth L. Steinthal
J. Blake Cunningham
David P. Mattern
KING & SPALDING LLP
101 Second Street, Suite 2300
San Francisco, California 94105
Tel.: (415) 318-1200
Fax: (415) 318-1300
ksteinthal@kslaw.com
bcunningham@kslaw.com
dmattern@kslaw.com

Counsel for Google LLC

/s/ Benjamin E. Marks
Benjamin E. Marks
Todd Larson
Aaron J. Curtis
David J. Bier
WEIL, GOTSHAL & MANGES LLP
767 Fifth Avenue
New York, New York 10153
Tel.: (212) 310-8000
Fax: (212) 310-8007
benjamin.marks@weil.com
todd.larson@weil.com
aaron.curtis@weil.com
david.bier@weil.com

Counsel for Pandora Media, LLC

/s/ Richard M. Assmus
Richard M. Assmus
MAYER BROWN LLP
71 South Wacker Drive
Chicago, Illinois 60606
Tel.: (312) 782-0600
Fax: (312) 706-9125
rassmus@mayerbrown.com

– and –

A. John P. Mancini
Jacob B. Ebin
Allison Aviki
Margaret Wheeler-Frothingham
MAYER BROWN LLP
1221 Avenue of the Americas
New York, New York 10020
Tel.: (212) 506-2500
Fax: (212) 849-5895
jmancini@mayerbrown.com
jebin@mayerbrown.com
aaviki@mayerbrown.com
mwheelerfrothingham@mayerbrown.com

– and –

/s/ Scott H. Angstreich
Scott H. Angstreich
Leslie V. Pope
Julius P. Taranto
KELLOGG, HANSEN, TODD,
FIGEL & FREDERICK, P.L.L.C.
1615 M Street, N.W., Suite 400
Washington, D.C. 20036
Tel.: (202) 326-7900
Fax: (202) 326-7999
sangstreich@kellogghansen.com
lpope@kellogghansen.com
jtaranto@kellogghansen.com

Counsel for Amazon.com Services LLC

Andrew M. Gass
Joseph R. Wetzel
LATHAM & WATKINS LLP
505 Montgomery Street
San Francisco, California 94111
Tel.: (415) 391-0600
Fax: (415) 395-8095
andrew.gass@lw.com
joe.wetzel@lw.com

– and –

Allison L. Stillman
Samir Deger-Sen
LATHAM & WATKINS LLP
885 Third Avenue
New York, NY 10022
Tel.: (212) 906-1200
Fax: (212) 751-4864
alli.stillman@lw.com
samir.deger-sen@lw.com

Counsel for Spotify USA Inc.

Proof of Delivery

I hereby certify that on Monday, January 24, 2022, I provided a true and correct copy of the Services' Joint Suppl. Br. Addressing Judges' Working Proposal (Public) to the following:

Nashville Songwriters Association International, represented by Benjamin K Semel, served via ESERVICE at Bsemel@pryorcashman.com

Johnson, George, represented by George D Johnson, served via ESERVICE at george@georgejohnson.com

National Music Publishers' Association (NMPA) et al, represented by Benjamin Semel, served via ESERVICE at Bsemel@pryorcashman.com

Signed: /s/ Todd Larson